

No. 15,181

In the

United States Court of Appeals

For the Ninth Circuit

v. 2977

JOHN P. DALEY, MINERVA B. DALEY, MORRIS
DALEY, ZELMA B. DALEY, WILLIAM RAD-
TKE, CLARA RADTKE and HOMER BOSSE,
Trustee of the Estates of Morris K. Daley,
Alice M. Daley, Susan R. Daley, James D.
Daley, Kathryn F. Daley and Peter D. Daley,
Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

Appellants' Supplemental Brief

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FILED
MAR 28 1957
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Appellants' Supplemental Brief

I.

INTRODUCTION

Under date of March 5, 1957, this Court requested counsel for both parties to file additional briefs on the question whether income may be reported on a completed contract basis where the contract, as here, is for a lesser term than one year.

As noted by this Court, this subject was not treated by either side in the earlier briefs filed herein. Appellants considered that

the issue of whether the Regulations prohibited the use of the completed contract method for contracts of less than 12 months duration had been settled by the case of *L. A. Wells Construction Co. v. Comm'r*, 46 BTA 302, aff'd (6th Cir., 1943), 134 F.2d 623, certiorari denied 319 U.S. 771.¹ In addition, Appellants believed that no such issue would or could be raised by the United States in this case, since Daley Brothers, during its many years in the construction business, had never performed a contract which took more than 12 months to complete, and yet the United States had stipulated that they had always kept their books and reported their income from construction contracts on the completed contract basis (Tr. 18).

In Appellants' brief in the District Court, the *L. A. Wells Construction Co.* case and the case of *Fort Pitt Bridge Works v. Comm'r*, 24 BTA 626, aff'd on this issue (3rd Cir., 1937), 92 F.2d 825, certiorari denied 303 U.S. 659, were cited with respect to the point, and Appellee cited no contrary authority. It seemed clear from the opinion of the District Court (at Tr. 105) that this issue, if there ever was one, was decided in favor of Appellant. Consequently, this question was not raised in Appellants' Statement of Points on Appeal (Tr. 251). The only authority addressed directly to the matter in the briefs before this Court is the single sentence in the language from the *Fort Pitt Bridge Works* case quoted on page 9 of Appellants' Opening Brief: "The contracts need not run for more than a year".

II.

SUMMARY OF APPELLANTS' POSITION

The Appellants do not rely and have not relied in their briefs upon Section 19.42-4² of the Regulations in claiming the right to

1. This is the case referred to by counsel for Appellants at the trial before the District Court. See Tr. 121.

2. The court has cited the regulation as "Regs. 111 (1943), Sec. 29.42-4." Regulations 111 were not effective until Oct. 26, 1943. Thus it is believed that Regs. 103 (1939), Sec. 19.42-4 were applicable for 1942. However, the language of both regulations is the same.

use the completed contract method of accounting for the Delta contract. Instead, they rely upon Section 41 of the Internal Revenue Code, reading as follows:

"The net income shall be computed * * * in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

and upon Regs. 103, Section 19.41-2 which says:

"Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."³

As will be seen, there are a large number of cases holding that the completed contract method of accounting is a method generally employed by construction contractors for contracts of less than 12 months duration, and that it clearly reflects income. Accordingly, it meets the statutory test of Section 41 of the Code.

So far as appears, the Commissioner has not argued in any of the decided cases that Reg. Sec. 42-4 is intended to limit the use of the completed contract method of accounting to contracts taking longer than 12 months to complete. On the contrary, the cases show that he has many times asserted, *with respect to contracts of less than 12 months duration*, that in his opinion the completed contract method of accounting must be used because required by the statute.

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3. cf. Sec. 1.446-1 of the Proposed Regulations under the 1954 Code: "^{*} ^{*} ^{*} A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income provided all items of income and expense are treated consistently from year to year."

III.

ARGUMENT

1. The Regulations have not been interpreted to limit the completed contract method of accounting to contracts of more than 12 months duration.

In order to place the many cases concerning this subject in proper perspective, the cases must be read in the light of the language of the Regulations in effect from time to time.

The earliest Regulations relating to construction contracts authorized the completed contract method without regard to the duration of the contract.⁴

Accordingly, several of the cases decided under the 1918 Act which hold that the completed contract method of accounting is applicable to contracts of less than 12 months duration, actually relied upon the completed contract Regulations in so holding.⁵

Starting with the Regulations under the 1921 Act, and thereafter until Regulations 103 were issued under the 1939 Code, all the Regulations defined long-term contracts as construction con-

4. Art. 36 of Regulations 45, applicable to the 1918 Act, provided as follows:

"Art. 36. *Long-term contracts*.—Persons engaged in contracting operations, who have uncompleted contracts, *in some cases perhaps* running for periods of several years, will be allowed to prepare their returns so that the gross income will be arrived at on the basis of completed work; that is, on jobs which have been finally completed any and all moneys received in payment will be returned as income for the year in which the work was completed. * * *" [Italics added.]

5. E.g. *Bent v. Comm'r* (9th Cir., 1932), 56 F.2d 99 affirming 19 BTA 181 (where the Board said "The fact that some of the contracts were performed within a year and some took longer, creates no inconsistency in the method and does not detract from a clear reflection of income"). The record on appeal in the *Bent* case reveals that the "Huntington Park Reservoir" job was started in September, 1920 and was completed in February, 1921 (R. 164) and that the "Rodeo Drain" job was started in October, 1920 and was completed in March, 1921 (R. 165). See also *James C. Ellis* (1929), 16 BTA 1225 (contract entered into in July, 1920 and completed prior to March 14, 1921, court holds the "long-term contract" regulations are applicable.)

tracts "covering a period in excess of one year."⁶ It appears that some of the cases decided during this period by the lower courts construed this language to mean that a "long-term contract" was one "covering a period including portions of two fiscal years" or "spanning a year end", rather than requiring that the contract take more than 12 months from start to finish. *Birkemeier v. Comm'r* (1939), 39 BTA 1072, 1074: ("The Commissioner determined that the Tanner Creek contract was a long term contract"—Tanner Creek job lasted only 10 months); *Hegeman-Harris Co. v. United States* (Court of Claims, 1938), 23 F. Supp. 450; *Lakeside Petroleum Co. v. U. S.* (N.D. Ill., 1932) 1 F. Supp. 31, 32; *Cameron, Joyce & Co. v. U. S.* (S.D. Iowa, 1937) 38-1 USTC 9168, 22 A.F.T.R. 1229.⁷

In addition to these cases, however, there are also a number of cases decided during this period upholding the completed contract method of accounting, or conceding that it may be used, without regard to the contract's duration without relying upon, and in

6. Art. 36 of Regulations 62 (1921 Act), 65 (1924 Act) and 69 (1929 Act); Art. 334 of Regulations 74 (1928 Act), and 77 (1932 Act); Art. 42-4 of Regulations 94 (1936 Act) and 101 (1938 Act):

"Long-term Contracts.—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article, the term 'long-term contracts' means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * *

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. * * *

7. See also *Bent v. Comm'r*, *supra*, in which the Regulations under the 1918 Act were sustained by this Court as applied to contracts of less than 12 months on the basis of reasoning that subsequent Revenue Acts made no change in the governing statutory provisions. It would seem to follow that the Court believed that the Regulations under the subsequent Revenue Acts were not intended to, and *could not* effect a change in the treatment of contracts of less than 12 months.

some cases without even citing, the Regulations relating to construction contracts. *L. A. Wells Construction Co. v. Comm'r* (1942), 46 BTA 302, aff'd (6th Cir., 1943), 134 F.2d 623, certiorari denied 319 U.S. 771; *Vang v. Lewellyn* (3rd Cir., 1929), 35 F.2d 283; *Harrison v. Heiner* (W.D. Penn., 1928), 28 F.2d 985; *Chapin Construction Co. v. Comm'r* (1925), 3 BTA 25, 27; *B. F. Patterson v. Comm'r* (1930), 21 BTA 8 (petitioner's practice was to complete work by last of November, Commissioner argues books kept on completed contract basis); *Fort Pitt Bridge Works v. Comm'r* (1931), 24 BTA 626, 641, aff'd on this issue (3rd Cir., 1937) 92 F.2d 825, certiorari denied 303 U.S. 659; *Orino v. Comm'r* (1936), 34 BTA 726. The *Orino* case said it was immaterial whether the contract was "long-term", because Section 41 of the statute governs.

Additional cases involving contracts of less than one year have been decided subsequent to the adoption of Regulations 103 Sec. 19.44-2 defining a "long-term contract" as one which covers "a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." *Jones v. Smith* (10th Cir., 1952), 193 F.2d 381, certiorari denied 343 U.S. 952; *Standard Paving Co. v. Comm'r* (10th Cir., 1950), 190 F.2d 330, aff'g 13 T.C. 425 (facts show "Gruber" and "Dalhart" projects each lasted only 7 months), certiorari denied 342 U.S. 860; *Jud Plumbing & Heating, Inc. v. Comm'r* (5th Cir., 1946), 153 F.2d 681, aff'g 5 T.C. 127 (used completed contract method for all contracts over \$100); *National Builders v. Comm'r* (1949), 12 T.C. 852, 858; *Ehret-Day Co. v. Comm'r* (1943), 2 T.C. 25, 32; *Brown & Root, Inc. v. Scofield* (W.D. Texas, 1953), 53-1 USTC 936, 44 A.F.T.R. 1325; *Anderson-Dougherty-Hargis Co., Inc. v. U. S.* (N.D. Cal., 1950), 96 F. Supp. 404.

Of the many cases previously cited which hold or clearly indicate that the completed contract method of accounting is applicable to all construction contracts, without regard to duration, the *L. A. Wells Construction Co.* case is perhaps the most explicit in its

reasoning and is the leading case on the subject. The pertinent facts were clearly expressed in the opinion of the Board of Tax Appeals, as follows (46 BTA at 305):

"The petitioner contends that it kept its books and filed its income tax returns on the accrual basis; that the Buffalo contract, which did not contemplate or require in excess of twelve months for completion, was not a 'long-term' contract as defined by the respondent's regulations, and that therefore the deduction of \$61,031.40 taken in its 1937 return as a reserve for loss should be allowed in order to clearly reflect its income. The respondent contends that, since the petitioner has consistently reported its taxable income from contracts begun in one year and completed in the following year on the complete contract basis, and since the Buffalo project was not completed until 1938, the allowance of the deduction sought by the petitioner would result in a distortion of its taxable income for both 1937 and 1938.

"* * * From the evidence it is apparent that the petitioner accounted for and reported its income by the completed contract method. So far as disclosed, the respondent has consistently accepted such method as correctly reflecting the petitioner's income and, we think, properly so. *H. Stanley Bent, supra*; *Alfred E. Badgley*, 21 B.T.A. 1055; *aff'd* 59 Fed. (2d) 203; *Russell G. Finn, Executor*, 22 B.T.A. 799; *Fort Pitt Bridge Works*, 24 B.T.A. 626; *affirmed* on this point, 92 Fed. (2d) 825; *certiorari denied*, 303 U.S. 659; *D. L. Wheelock*, 10 B.T.A. 540.

"With respect to the Buffalo project the petitioner, under the guise of a reserve for loss, seeks to depart from its established practice of accounting for and reporting income and to deduct in its 1937 return an amount representing a prorated portion of its total estimated loss on the project. Where, as here, the method of accounting employed by the taxpayer clearly reflects income, to permit such departure would not result in the petitioner's net income being computed 'in accordance with the method of accounting regularly employed in keeping the books of such taxpayer', as is required by the statute. Sec. 41, Revenue Act of 1936. The allowance of such departure would, as respondent contends, result in a distortion of income for both 1937 and 1938. We are of the opinion that the action of the respondent with respect to this

issue is correct, and it is therefore sustained. *Russell G. Finn, Executor, supra.*

"The petitioner contends * * * that the Buffalo contract did not cover a period in excess of one year and that to hold as applicable here the completed-contract method of reporting income involved in said decisions and specifically provided for in Article 42-4(b) of Regulations 94, would nullify the obvious intent of the regulations as disclosed in the definition of long term contracts. It is true that the decisions in the cases mentioned, except the *Badgley* case, involved taxable years controlled by the Revenue Act of 1918. However, the *D. L. Wheelock* case involved years controlled by the 1918 and 1921 Acts and the *Badgley* case involved years controlled by the Revenue Acts of 1921, 1924 and 1926. The regulations under all acts since the Act of 1918 contain the same definition of long term contracts as appears in Article 42-4 of Regulations 94. The rule in the above mentioned cases is grounded not on the length of time covered by the contracts, but on the taxpayer's method of keeping books and reporting income, and, as we said in the *Bent* case, 'The fact that some of the contracts were performed within a year and some took longer creates no inconsistency in the method and does not detract from a clear reflection of income' "

It should be noted that the *L. A. Wells Construction Co.* case was affirmed by the Court of Appeals for the Sixth Circuit "upon the grounds and for the reasons set forth in the opinion of the Board." 134 F.2d 623. Certiorari was denied by the United States Supreme Court, 319 U.S. 771.

The *Wells* case is also an example of the cases emphasizing the importance of consistency in the application of accounting methods in order to avoid distortion of the income of the taxpayer from year to year. Regardless of what may be said in favor of the District Court's view that Daley Brothers Delta Venture was an entity apart from the Daley Brothers partnership, the effect of singling out the Delta contract and requiring that Appellants' report income from that contract on the accrual basis would be to *impose inconsistency* upon them, rather than to *uphold consistency*. Daley Brothers Delta Venture was not a taxpayer. The partnership return

which was required from it was for informational purposes only. The testimony was that the taxpayers, the individual plaintiffs, had consistently used the completed contract method since 1921 and thereafter until the time of the trial (Tr. 189-190).

It is of particular significance that in the *L. A. Wells Construction Co.* case no argument was made by the Commissioner that his Regulations prohibited the use of the completed contract method of accounting for contracts of less than 12 months. On the contrary, the Commissioner argued that if the accrual method, rather than the completed contract method, was used by the taxpayer for its short-term contracts, income would not be clearly reflected. The court agreed.

As a matter of fact, *no* case has been found from which it appears that the Commissioner has argued that the completed contract method of accounting may not be used for contracts taking less than 12 months to complete. On the other hand, there are many cases in addition to the *Wells* case in which the Commissioner has required or attempted to require that the taxpayer use the completed contract method of accounting for contracts of less than 12 months on the grounds that this was the only method which would clearly reflect income. Among these are *Bent v. Comm'r* (9th Cir., 1932), 56 F.2d 99, aff'g 19 BTA 181; *B. F. Patterson* (1930), 21 BTA 8; *Birkemeier v. Comm'r* (1939), 39 BTA 1072; and *Anderson-Dougherty-Hargis Co. v. U. S.* (N.D. Cal., 1950), 96 F. Supp. 404.

In addition to the *Bent* case, which has been previously cited and discussed, there are two other 9th Circuit cases involving the long-term contract regulations. These cases are *Ross B. Hammond Inc. v. Comm'r* (9th Cir., 1938), 97 F.2d 545, and *E. E. Black, Ltd. v. Alsop* (9th Cir., 1954) 211 F.2d 879. Neither case is directly related to the issue discussed in this brief, but both of these cases also support Appellants' position.

The *Hammond* case involved a long-term contract. The taxpayer had been on the completed contract method of accounting and had switched to the percentage of completion method for the particular

long-term contract involved, without either obtaining the consent of the Commissioner or submitting the certificates of architects or engineers required by the regulations in order to show the percentage of completion. Accordingly, it was held that the taxpayer was not entitled to use the percentage of completion method since these requirements had not been met. While the particular contract involved in the *Hammond* case appears to have had a duration of more than 12 months, it is clear from the opinion of the Board of Tax Appeals (36 BTA, 497 at 502) that taxpayer had used the completed contract method for *all* construction contracts, and not only for those extending over a period of more than 12 months. The transcript of the record on appeal in the *Hammond* case confirms this. (Stip. of Facts IV, VI, X; Tr. of Rec. pages 16-19).

The case of *E. E. Black, Ltd. v. Alsop*, which has been discussed in the previous briefs, is the case holding that the regulation requires final completion and acceptance, rather than substantial completion. The record in that case shows that the contract there involved was entered into on July 28, 1944 and that it was substantially completed on April 27, 1945, a period of less than one year. (Tr. of Rec., pages 25-26). It was finally completed and accepted in 1946.

The Government argued in the *Black* case that "final completion and acceptance" as used in the Regulation meant "substantial completion", and that since the contract was substantially completed on April 27, 1945, the profit from the contract should have been reported in 1945 on the completed contract basis. Thus, there was implicit in the Government's argument that the completed contract method was available for a contract of less than 12 months. Putting the matter another way, if the Government had been correct that "final completion and acceptance" means "substantial completion", and if the regulations prohibit the use of the completed contract method for contracts of less than 12 months, then the contract involved in the *Black* case would not have qualified for completed contract treatment, and, as a matter of fact, the taxpayer would have been required to report a portion of the in-

come from the contract on the accrual or cash basis as of December 31, 1944! There is no inkling in the briefs or in the court's opinion that this was an issue that was or ought to have been before the court. It also demonstrates the administrative difficulties that would be presented if the question of whether the completed contract basis could be used depended upon whether the contract happened to take more or less than 12 months to complete. In almost all cases, of course, the contractor does not know in advance on what date the contract will be finally completed and accepted. In many cases, therefore, he would not know, at the time his tax return was required to be filed for a year in which he commenced work on a contract, whether he was entitled to use the completed contract method of accounting for that contract (and thus defer the income) or whether he would be required to show partial results in his return. Certainly if the Regulation is, at this late date, to be interpreted in such a manner as to create an administrative burden of this type, it would be incumbent upon the Appellee to present to this Court the most cogent and persuasive reasons for sustaining its validity. Moreover, the consistent interpretation and concession by the Commissioner that his regulation does *not* prevent the use of the completed contract method for short term contracts, which runs throughout all the previous cases, should be persuasive that the regulation was not *intended* to do so.

Appellants treated the Delta contract as if it had been completed in 1942. If this court agrees with Appellants that this can be fairly characterized only as an application of the completed contract method of accounting,⁸ then Section 41 of the Code and the foregoing cases clearly establish Appellants' right to correctly apply that method. The fact that the Delta contract was completed in less than 12 months is irrelevant.

Section 41 also says that if (i) the taxpayer did not regularly employ a method of accounting, or if (ii) the method employed did not clearly reflect the income, then the computation shall be

8. See *Edward Crump, Jr. Inc. v. Comm'r* (3rd Cir., 1948), 169 F.2d 725 discussed *infra*, page 20.

made by a method which "in the opinion of the Commissioner,"⁹ clearly reflects the income. Unless the method employed in connection with the Delta contract was the completed contract method, it was *neither* "regularly employed" nor did it "clearly reflect the income."¹⁰ Since the above cases are clear evidence that in the opinion of both the Commissioner and the courts the completed contract method of accounting clearly reflects the income from short term contracts, Appellants' right of recovery by that method is clear under the statute.

2. The completed contract method of accounting is particularly applicable to contracts of short duration.

Certainly, the foregoing demonstrates that the cases overwhelmingly support the position that the completed contract method of accounting is appropriate for contracts of less than 12 months duration.¹¹ However, the cases contain little, if any, basic analysis of the problem. Moreover, there has been no indication in the cases or elsewhere of *why* the Regulations deal only with contracts requiring more than 12 months to complete. It is Appellants' contention that analysis will show that the completed contract method of accounting is actually *more* appropriate in the case of short term construction contracts than in the case of long-term contracts, and that the reason why the regulations do not also deal with construction contracts of less than 12 months is related not to the completed contract method of accounting referred to in those

9. If the taxpayer wishes to correct his return by switching from a method which does not reflect income to one which does, the Commissioner may not withhold his consent simply because more tax would be collected from the erroneous method. *Key Largo Shores Properties, Inc. v. Comm'r* (1930), 21 BTA 1008; *Reynolds Cattle Co. v. Comm'r* (1934), 31 BTA 206.

10. In addition to the authorities cited in Appellants' previous briefs, see the general discussion in the Note, "Clearly Reflecting Income," 54 Columbia Law Review 1267 (1954).

11. As for the commentators, see, e.g., "Can Completed Contract Basis Be Used for All Jobs Extending into Two Taxable Years?" 94 Jo. of Accountancy 708 (December 1952); Wagman "Tax Accounting for Long-Term Contracts" 33 Taxes—The Tax Magazine 277 (April, 1955).

regulations, *but to the percentage of completion method*, which the regulations say is an alternative method of accounting available only in the case of long-term contracts.

There are, so far as is known to Appellants, only two reasons why the completed contract method of accounting is used almost universally by construction contractors for both tax and other purposes. Perhaps the principal reason, as stated by this court in the *Bent* case (quoted at page 27 of Appellants' Opening Brief), is that because of the nature of contracting operations it cannot be known what the profit or loss may be until the contract is completed or accepted. See also GCM 7998, IX-2 CB 206 in which the General Counsel for the Bureau of Internal Revenue made the same point, as follows:

"One of the reasons why permission to report on a completed contract basis is given in the case of building, installation, and construction contracts is the fact that there are changes in the price of articles to be used, losses and increased costs due to strikes, weather, etc., penalties for delay, and unexpected difficulties in laying foundations which make it impossible for any construction contractor, no matter how carefully he may estimate, to tell with any certainty whether he has derived a gain or sustained a loss until a particular contract is completed."

This reason, on its face, is one which is applicable to any construction contract which spans a year end, and not only to those contracts which also last for more than 12 months. As a matter of fact, one of the four contracts involved in the *Bent* case took only 6 months to complete, while another was of only 5 months duration (See footnote 5 *supra*).

The second, and in some cases even more persuasive reason for the use of the completed contract method of accounting, is the frequent lack of correlation under the terms of such contracts between the expenses incurred by the contractor and the payments made by the owner to the contractor. When payments lag behind costs, as they did in connection with the Delta contract, distortion is bound to follow if the books are closed on the job for an interim period

prior to final acceptance. This is the point made in paragraph 2 of Accounting Research Bulletin No. 45, and in the article from the Journal of Accountancy, which are quoted, respectively, in footnotes 8 and 9 on pages 14 and 15 of Appellants' Closing Brief. See also *Lakeside Petroleum Co. v. U. S.* (N.D. Illinois), 1 F. Supp. 31, at 32 where, after quoting the regulation, the court says:

"In other words, long-term contracts were contracting operations where work was done under the contract and expenditures and expenses were incurred thereunder often in different years from the time payments were received by the contractors."

See also *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150, 152, 75 L.Ed. 383, where this aspect of the completed contract method of accounting is discussed and approved.

It seems patent, also, that this second reason for the use of the completed contract method of accounting is applicable to any construction contract which spans a year end, and not only to those contracts which also last for more than 12 months. As a matter of fact, one would suspect that the shorter the period of the contract, the less likelihood is there that correlation between expenses and progress payments will be attempted, since the contractor will not have long to wait for full payment in all events.

We have seen that the reasons why the completed contract method of accounting is used by contractors are equally persuasive for all construction contracts, without regard to duration. But how about the disadvantages of the completed contract method of accounting? Do these apply equally to both long and short term contracts?

There are several disadvantages to the completed contract method of accounting, both for the contractor and for the tax collector. From the contractor's standpoint, the completed contract method of accounting, when applied to a profitable contract, may bunch the earnings from several years' activities into a single taxable period. The result, of course, would be a larger tax than would otherwise be payable, because of the progressive rate structure. If the contract is not profitable, the result may be to lump a large loss

all into one year, which otherwise might have been used to offset income earned from other sources in several years.

From the standpoint of the revenues, the disadvantage of the completed contract method of accounting is that it may delay for several years the time for the payment of taxes. In a sense, the contractor is financing his operations out of delayed tax payments.

From a simple statement of these disadvantages, it is apparent that the completed contract method of accounting is *more* appropriate for contracts lasting *less* than 12 months. The disadvantages are all directly proportional to the length of the contract!

Why, then, do the regulations refer only to contracts lasting for more than 12 months? And since the Commissioner consistently agrees that the completed contract method of accounting should be used for contracts lasting less than 12 months, why aren't the regulations expanded to cover all construction contracts, without regard to duration?

The answer to these questions lies in an appreciation of the fact that the regulation deals with an accounting problem, and is intended to clarify a doubtful question of accounting procedure. In the case of short term contracts there is no dispute among accountants—the use of anything other than the completed contract method of accounting for short term lump sum construction contracts is heresy! No regulation is necessary to tell the accountant or the courts that the completed contract method meets the tests of the statute when applied to short term contracts. In the case of long term contracts, however, there are competing considerations. Theoretically, no income is earned until the contract is completed and accepted. And because of the hazards of the construction business the conservative approach is to wait until the contract is completed before estimating profits. But the disadvantages of the completed contract method when applied to contracts of extended duration create pressures on the accountant to make annual estimates of the profit earned, based on the percentage of completion.

The accountants' dilemma is clearly expressed in the literature. For example in Gilman, *Accounting Concepts of Profit* (1939), at

pages 114-116, we find the following review of the authorities and the problem:

"CONSTRUCTION CONTRACTS. An interesting income problem is noted in connection with large construction contracts. Montgomery has described the problem in the following words:

'* * * a contractor might be engaged for a period of three years on a single large project to the exclusion of all other work. If his books were kept on a completed contract basis, he would show losses in the first two years, and the third year would reflect the profit of three years' operations.'

"Referring to the same type of situation, Kester intimates that: 'To withhold profits, if earned, until the completion of the contract might work a real injustice.' The injustice mentioned must refer to injustice to stockholders, particularly in the case of those companies whose shares are actively traded. A practical income tax problem also is involved which may well be one of the factors of injustice.

"Sweeney, in his *Stabilized Accounting*, clearly recognizes that the treatment of unfinished long-term contracts is an exception to the general rule and asserts that this exception is for the sake of expediency.

* * *

"The common recognition of interim income on long-term contracts is undoubtedly fair to all concerned, stockholders, management, creditors, and government. Any change to a more rigorous basis might result in burdensome tax inequity. None the less, it must be insisted that such interim profit estimates under the bare conditions set forth are not only not 'true earnings' but are not, as a matter of fact, realized earnings at all."

In *Montgomery, Auditing Theory and Practice Vol. II (1922)*, at pages 487-489 ("Contractors' Accounts"), the following is found:

"INCOME TAX RETURNS.—For income tax purposes contractors can elect to return as income only those amounts

received in payment of jobs finally completed, as brought out in Article 36, Regulations 62, quoted below:

[Quoting the Regulations under the 1918 Act]

* * *

"While this method protects the contractor, in that it minimizes the possibility of paying taxes on profits which may not be earned, yet it is hardly fair in the case of a large building contract extending over several fiscal years. In the latter case it can hardly be claimed to be improper to take at least a part of the profit on the work already done provided the percentage of the work completed has been estimated on a conservative basis and a liberal allowance has been made for contingencies. * * *

"After all, however, the best method, except in the cases above mentioned, is to ignore entirely profits which may have accrued on uncompleted contracts."

Accounting Research Bulletin No. 19 of the American Institute of Accountants also sets forth the accountants approach. In paragraph 1 is found the following:

"In the case of manufacturing, construction or service contracts, profits are not ordinarily recognized until the right to full payment has become unconditional, i.e., when the product has been delivered and accepted, when the facilities are completed and accepted, or when the services have been fully and satisfactorily rendered. This accounting procedure has stood the test of experience and should not be departed from except for cogent reasons.

It is, however, a generally accepted accounting procedure to accrue revenues under certain types of contracts, and thereby recognize profits, on the basis of partial performance, where the circumstances are such that aggregate profit can be estimated with reasonable accuracy and ultimate realization is reasonably assured. *Particularly where the performance of a contract requires a substantial period of time from inception to completion, there is ample precedent for pro rata recognition of profit as the work progresses, if the total profit and the ratio of performance to date to complete performance can be reasonably computed and collection is reasonably assured. Depending upon the circumstances*

such partial performance may be established by deliveries, expenditures or percentage of completion otherwise determined. *This rule is frequently applied to long-term construction and other similar contracts.*" [Italics added.]

The other leading accounting authorities are to the same effect. See Kester, *Advanced Accounting* (4th Ed., 1946) at page 401; Finney, *General Accounting* (1941) at page 252; Holmes, *Auditing Principles and Procedure* (Revised Edition, 1947), at page 577.

With this background, Regulation 103 Sec. 19.42-4 makes considerably more sense. It tells the taxpayer and his accountant that in the case of construction contracts lasting for more than 12 months the percentage of completion method is available, despite the fact that it results in the reporting of income not earned and losses not sustained. It also tells the taxpayer and his accountant that the completed contract method may still be used in the case of such long term contracts, despite the fact that the use of such method for such contracts may result in the deferral of taxes for an extended period of time.¹² Without this guide in the Regulations it might be expected that taxpayers, accountants and the courts would all have considerable difficulty in weighing the competing practical considerations applicable to long term construction contracts against the theoretical tests of income realization and the requirements of revenue collection on an annual basis.¹³ *There are no competing factors in the case of short term contracts. Everything points to the completed contract method as the only acceptable method, and so regulations are unnecessary.*

12. Compare the first sentence of Sec. 42-4(a) with the first sentence of 42-4(b):

"(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion."

"(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted *if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income.*" [Italics added.]

13. See, e.g. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150, 75 L. Ed. 383.

The accounting authorities previously cited are not the only support for Appellants' rationale of the regulations relating to construction contracts. Congress itself provided strong support for this interpretation when, in 1942, it enacted Section 736(b) of the Internal Revenue Code, relating to the excess profits tax. This section was designed to permit corporations using the completed contract method for income tax purposes to switch, in the case of long-term contracts only, to the percentage of completion method for excess profits tax purposes because of the distortion which would result in excess profits net income from lumping the earnings of several years into the year of completion.¹⁴ The relevant portions of this section of the Code provided as follows:

"(b) Election on long-term contracts.—In the case of any taxpayer computing income from contracts the performance of which requires more than 12 months * * * it may elect * * * to compute, in accordance with regulations prescribed by the Commissioner with the approval of the Secretary, such income upon the percentage of completion method of accounting. * * *".

There are two extremely interesting aspects of this language. In the first place, it is clear from the Committee report quoted in footnote 14 that the relief was intended to be given only because the completed contract method of accounting, when applied to contracts of more than 12 months duration, would unfairly bunch income. Yet the section is not, by its terms, limited to taxpayers who had used the completed contract method of accounting in "computing income from contracts". It is respectfully suggested that a fair inference is that Congress believed

14. See Sen. Rep. No. 1631, 77th Cong., 2d Sess. (1942), p. 208 (1942-2 Cum. Bull. 657):

"Your committee has added a new subsection (b) to section 736 to provide relief to taxpayers reporting income from long-term contracts upon the completed contract method of accounting. Such income is bunched in the year in which it is reported and unless it is spread out over the period of the contract under which the work has been performed a distorted picture of the taxpayer's true earnings for such year is presented * * *."

that the only method available for "computing income from contracts", other than the percentage of completion method, was the completed contract method.

The other significant feature of this section is that Congress itself provided that for excess profits tax purposes the percentage of completion method was available as an alternative to the completed contract method only in the case of contracts extending for a period of more than 12 months. It is Appellants' position that Regs. 103, Sec. 19.44-2 was designed to establish the same rule for income tax purposes.

One of the few cases interpreting Section 736(b) of the Excess Profits Tax Law is *Edward Crump, Jr. Inc. v. Comm'r* (3rd Cir., 1948), 169 F.2d 725. This case makes it clear that while Section 736(b) permitted the use of the percentage of completion method only for contracts taking longer than 12 months to complete, that section raised no implication that the completed contract method could be used only for such contracts. For in one breath the court noted that the taxpayer had always reported income on the completed contract method and that the only contract that it had ever had which took more than 12 months to complete was the one before the court. Thus, the court said (at pg. 726):

"The taxpayer is a Pennsylvania building construction corporation. It kept books on a calendar year basis. The income tax returns through 1942 were made on a completed contract basis. The only long-term contract as defined in Section 736(b) (performance of which requires more than twelve months) it ever had was the one in question."

The court is also respectfully requested to read the *Crump* case from the standpoint of whether the method of accounting used by Appellants in connection with the Delta contract should be designated the "accrual" method or the "completed contract" method. In the *Crump* case the contract was actually completed in 1942, but the accountant testified that the president of the company instructed him to treat it as if it were completed in 1941. The court noted that since the 1941 return "carried an estimate

of the total contract profit" it was proper to conclude that the method of accounting adopted with respect to this contract was the completed contract method of accounting. Since the contract was actually completed in 1942, rather than in 1941, the entire contract profit was held to have been properly shifted from 1941 to 1942. Counsel for Appellants have taken the liberty of referring to this aspect of the *Crumph* case in this Supplemental Brief only because of the very great similarity of the facts of that case to the facts of this one. The case was not discovered previously because it was digested under the excess profits tax law, a field not researched in connection with the previous briefs.

CONCLUSION

The completed contract method of accounting may, *and should*, be used where the contract, as here, is for a lesser period than one year.

Respectfully submitted,

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March, 1957.